Office of Chief Counsel
Internal Revenue Service

memorandum

CC:NER:BRK:TL-N-3169-99
HNAdams

date: June 23, 1999

to: District Director, Brooklyn
Chief, Examination Division
Attn: Anthony Manzella, Group 1203

from: District Counsel, Brooklyn

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subject: **Request for Legal Opinion - [redacted]**
Tenant Allowance Issue
Years: [redacted]

U.I.L. 61.16-16

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BACKGROUND

Reference is made to your request of May 13, 1999 that we evaluate the merits of the position taken in the Revenue Agent's Report relating to the fiscal years of [redacted] and subsidiaries (collectively referred to herein as "[redacted]") ended [redacted] and [redacted] ("the RAR") that construction allowances received by [redacted] should be included in its taxable income. Although the years that are the subject of the RAR are currently under the jurisdiction of the Appeals division, you are considering whether to apply the same position to [redacted]'s three subsequent years. In connection with your request, you provided us with a copy of the RAR and [redacted]'s [redacted] protest to that RAR ("the

protest"). Our understanding of the facts is based on the facts set forth in the aforementioned RAR and protest.[1/]

ISSUE

Whether construction allowances received by [redacted] should be included in its gross income?

CONCLUSION

Whether the construction allowances received by [redacted] should be included in its gross income hinges on whether it should be considered the owner of the leasehold improvements paid for with the allowances. That issue is a factual one to be decided by applying the facts and circumstances test set forth in the examination division's [redacted] coordinated issue paper entitled "Tenant Allowances to Retail Store Operators." Based on the facts described in the the RAR and protest, we believe that, although an argument could be made that [redacted] should be considered the owner of the leasehold improvements for tax purposes, [redacted] has the more persuasive argument on this issue to the extent that the leasehold improvements were permanently attached to and made part of the premises.

We believe that the Service would have a stronger argument with respect to any improvements that were not permanently attached to and made part of the premises. In that case, the improvements would constitute personal property, legal title would not automatically vest in the landlords by operation of law, the improvements might be covered by [redacted] s personal property insurance of which it was the beneficiary, and it would appear that [redacted] might have the remainder interest in the improvements.

DISCUSSION

Coordinated Issue Paper

The tax treatment of tenant allowances was, until the examination division decoordinated the issue on June 1, 1999, the subject of a coordinated issue paper issued by the examination division in connection with the Retail Industry Specialization Program ("ISP"). The coordinated issue paper took the position that allowances received by retail tenants such as [redacted]

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[1] You informed us on [redacted] that you agree with the facts set forth in the protest.

are:

- includable in their gross income (unless excluded by some section of the Internal Revenue Code) to the extent the allowances are "received from the landlord as lease inducements and expended by [the tenant] as it sees fit or on specific leasehold improvements that are owned by [the tenant]", and

- excludable from their gross income to the extent the allowances are expended by the tenant on assets that are owned by the landlord.

The coordinated issue paper takes the position that for federal tax purposes ownership of leasehold improvements is determined by applying the benefits and burdens of ownership test. The coordinated issue paper states that the Tax Court has considered the following factors in applying that test to determine who owns leased property for tax purposes:

> (1) whether legal title passes; (2) how the parties treat the transaction; (3) whether an equity interest was acquired in the property; (4) whether the contract creates a present obligation on the sellers to execute and deliver a deed and a present obligation on the purchaser to make payments; (5) whether the right of possession is vested in the purchaser; (6) which party pays the property taxes; (7) which party bears the risk of loss or damage to the property; and (8) which party receives the profits from the operation and sale of the property.

The coordinated issue paper states that some of those factors will be helpful in determining whether a tenant owns leasehold improvements. In addition, the coordinated issue paper identifies four other factors that are relevant to the determination of whether a tenant should be treated as the owner of leasehold improvements.[2/] It states that in the context of leasehold improvements:

> certain additional factors indicate that the tenant owns such improvements, e.g., the tenant carries personal property and liability insurance on the leasehold improvements; the tenant

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[2] The court stated in In re Elder-Beerman Stores Corp., 97-1 U.S.T.C. ¶ 50,391 (Br. S.D. Ohio 1997), the only case to address the position set forth by the Service in the coordinated issue paper, that it could find no legal support for these other factors.

is the beneficiary under those policies; the tenant is responsible for replacing the leasehold improvements if they wear out prior to the end of the lease term; and, if the usefulness of the leasehold improvements extends beyond the lease term, the tenant has the remainder interest in the improvements.

Appeals Settlement Guidelines

The Appeals division also decoordinated the tenant allowance issue effective June 1, 1999. Until then, Appeals Settlement Guidelines were in effect. Consistent with the position taken in the coordinated issue paper, the Appeals Settlement Guidelines provide in part that "in those cases where amounts are received from the landlord as lease inducements and expended by the tenant as it sees fit or on specific leasehold improvements that are owned by the tenant, the government should receive a substantial concession or litigation should be recommended." In contrast, the guidelines provide that "where amounts are received from the landlord and expended by the tenant on assets that are owned by the landlord, concession should be recommended."

Like the coordinated issue paper, the Appeals Settlement Guidelines provide that ownership of leasehold improvements for federal tax purposes must be determined by applying the benefits and burdens of ownership test.

Code Section 110

Code section 110, which provides that certain tenant allowance received in connection with short-term leases of retail space are not includable in income, applies only to leases entered into after August 5, 1997. As a result, it does not apply to tenant allowance received in connection with leases entered into during [redacted]'s years ended [redacted], [redacted], and [redacted]. The legislative history to Code section 110 states that Congress did not intend for section 110 to create any inference as to the treatment of tenant allowances that are not covered by the provision. H.R. Conf. Rep. No. 105-220, at 658-59 (1997).

Continued Viability of Approach Taken in Coordinated Issue Paper

We discussed the continued viability of the position taken in the coordinated issue paper with our counsel counterparts on the Retail ISP team. They have advised us that, except for cases to which Code section 110 applies, the legal analysis set forth in the coordinated issue paper continues to reflect the Service's

position.

Revenue Agent's Report

The revenue agent's report concludes that [redacted] should be deemed the owner of the leasehold improvements funded by the tenant allowances at issue because it bore the following benefits and burdens of ownership:

- [redacted] treated itself as the owner of the improvements - they were based on [redacted]'s plans, were constructed to its specifications under its control and supervision, and were recorded as assets on its books. In addition, [redacted] was listed as the owner of the improvements on standard American Institute of Architects Document [redacted];

- [redacted] hired, supervised, and paid the contractors who constructed the leasehold improvements, thus assuming the risk of construction defects;

- [redacted] had the right to possess the improvements during the terms of the long-term leases of the properties to which the improvements were made and ran the risk that the improvements would lose their value by becoming obsolete during those terms;

- [redacted] bore the risk of loss or damage to the improvements because it was required to maintain them and pay any repair or replacement costs;

- [redacted] was responsible for the real estate taxes on the portion of the shopping center that they occupied based on the proportion of the center's square footage that it occupied; and

- [redacted] was responsible for purchasing personal property and liability insurance on the leasehold improvements.

Taxpayer's Protest

In its protest, [redacted] applies the factors set forth in the coordinated issue paper and argues that they, and In re Elder-Beerman Stores Corp., 97-1 U.S.T.C. ¶ 50,391 (Br. S.D. Ohio 1997), support the conclusion that its landlords owned the leasehold improvements for tax purposes. [redacted] argues that:

1. Legal Title - Legal title to the leasehold improvements was always vested in its landlords as the improvements were

attached to buildings to which its landlords had legal title;

2. How the Parties Treated the Transaction - [redacted] always treated the leasehold improvements as property of its landlords as it did not reflect leasehold improvements paid for by tenant allowances as its assets on its books and records and did not depreciate them. [redacted] explains that although it debited an asset account to record all of the leasehold improvements made to facilities it occupied, those debits were offset to the extent the improvements were paid for by tenant allowances by credits to a negative asset account. Only the net of the two accounts was reported as an asset on its financial statements and SEC filings. [redacted] explains further that although it computed depreciation on both the debits and credits (negative depreciation on the credits), it netted those amounts to determine the depreciation expense it reported on its financial statements and SEC filings, in effect reporting depreciation on only the portion of the leasehold improvements that it paid for itself. [redacted] explains in footnote 8 of its protest that it was listed as the owner of the improvements on American Institute of Architects Document [redacted] because it in fact owned a significant portion of the improvements in each case -- the portion that was not reimbursed by tenant allowances.

3. Whether [redacted] Acquired an Equity Interest in the Leasehold Improvements - It acquired no equity interest in the leasehold improvements.

4. Whether [redacted] had a Right to a Deed to the Leasehold Improvements - It never received a deed to the leasehold improvements.

5. Whether [redacted] Received the Right to Possess the Leasehold Improvements - It received the right to possess the leasehold improvements during the terms of its leases, but that right is consistent with its status as a tenant and with the status of its landlords as lessors.

6. Whether [redacted] was Required to Pay the Property Taxes on the Leasehold Improvements - Although it was required to pay its share of its landlords' real property taxes as additional rent, the real property taxes that it was required to pay were not computed based on tenant improvements.

7. Which Party Bore the Risk of Loss or Damage to the Leasehold Improvements - Its landlords bore the risk of loss or damage

to the leasehold improvements as its leases provided that its landlords were required to repair or rebuild the premises to the same state as existed before any fire or other casualty. Although it was required to maintain exposed portions of the leasehold improvements in good repair, that requirement is typical of the obligation imposed on tenants to maintain rented property and shows that the landlords believed they had an interest in the improvements to protect.

8. Which Party Receives the Profits from the Operation and Sale of the Property - Although it would receive profits from the use of the leasehold improvements during the terms of its leases, its landlords would receive rents from the improvements during the terms of the leases and the profits from the improvements at the end of the leases.

9. Whether [redacted] Carries Personal Property and Liability Insurance on the Leasehold Improvements - Its landlord was generally required to procure all-risk property insurance covering all of the premises, including the leasehold improvements. [redacted] was generally required to procure all-risk insurance covering only personal property, which did not include leasehold improvements. Both it and its landlords were required to purchase general commercial liability insurance for their own operations at the premises and to list the other as a named insured. Although it was required to pay the cost of its landlords' all-risk property insurance covering the leasehold improvements, those payments were characterized by the leases as additional rent.

10. Who was the Beneficiary Under the Policies - Its landlords were the beneficiaries of the policies that covered damage to the leasehold improvements.

11. Who was Responsible for Replacing the Leasehold Improvements if the Wear Out During the Lease Term - Its landlords are not responsible for replacing the leasehold improvements if they wear out during the lease terms but neither was [redacted] as it was entitled to return the premises at the end of the lease terms in the same condition it received them "reasonable wear and tear and casualty excepted."

12. If the Usefulness of the Leasehold Improvements Extends Beyond the Lease Term, Who has the Remainder Interest - If the usefulness of the leasehold improvements extends beyond the lease terms, its landlords have the remainder interests because they became the owners of the improvements after the

[redacted].

Assessment

We believe that [redacted]'s explanation of its bookkeeping for the leasehold improvements neutralizes the argument that it treated improvements that were paid for with tenant allowances as its own property. In addition, we think [redacted]'s explanation of why it was listed as the owner of all of the leasehold improvements on American Institute of Architects Document [redacted] undermines the support that fact provides the Service.

[redacted]'s argument that its involvement in the construction process does not support its ownership of the leasehold improvements is supported by the Elder-Beerman case. As the court reasoned in that case, tenants and landlords can have valid business reasons for allowing tenants to assume responsibility for the construction of leasehold improvements.

As [redacted] notes, the Service's argument that its right to possess the leasehold improvements during the terms of its leases indicates its ownership of the improvements is contrary to the court's analysis in the Elder-Beerman case. Moreover, the requirement that landlords repair or rebuild the leasehold improvements in the event of a fire or other casualty undermines the Service's argument that [redacted] bore the risk of loss or damage to the improvements.

Similarly, the Service's argument that the requirement that [redacted] reimburse landlords for property taxes indicates that it was the owner of the leasehold improvements is undermined by the fact that the property tax reimbursement was based on square footage rather than the value of leasehold improvements. Moreover, as the court recognized in Elder-Beerman, the obligation to reimburse a landlord for property taxes is a contractual term that is typical of a net lease, and does not relieve its landlord of its ultimate responsibility to pay the tax. The Tax Court has recognized repeatedly when applying the benefits and burdens test to determine ownership in a sales-leaseback context that the use of a net lease requiring a lessee to pay taxes and insurance on the leased property is generally considered a neutral factor. Levy v. Commissioner, 91 T.C. 838, 860 (1988) and cases cited therein.

Finally, the Service's argument that the requirement that [redacted] purchase personal property insurance and pay for liability insurance indicates that [redacted] was the owner of the leasehold improvements is rebutted by [redacted]'s argument

that its landlords were required to procure all-risk property insurance covering the leasehold improvements and that the personal property insurance it was required to purchase did not generally cover leasehold improvements. Although [redacted] was required by its leases to reimburse its landlords for pro rata amounts of their insurance costs, as the court recognized in Elder-Beerman, net leases typically obligate tenants to reimburse landlords for insurance premiums. That analysis is consistent with the Tax Court's position that the existence of a net lease is a neutral factor in determining ownership in a sales-leaseback context. See Levy v. Commissioner, supra at 860 and cases cited therein.

Based on the foregoing, it appears that [redacted] has a relatively strong argument that the factors identified in the coordinated issue paper are either neutral or favor its position that it should not be considered the owner of leasehold improvements that were permanently attached to premises it rented. As a result, we conclude that the Service would face substantial hazards if it attempted to litigate this issue.

The analysis would be different to the extent that any of the leasehold improvements that were paid for with tenant allowances were not permanently attached to the premises that [redacted] rented. Those improvements might constitute personal property rather than real property. To the extent the improvements constitute personal property, legal title would not automatically vest in [redacted]'s landlords by operation of law, the improvements might be covered by [redacted]'s personal property insurance of which it was the beneficiary, and it would appear that [redacted] had the remainder interest in the improvements. It is unclear, however, whether any substantial portion of the leasehold improvements at issue were not permanently attached to the premises that [redacted] rented.[3/]

You should be aware that, under routine procedures that have been established for opinions of this type, we have referred this memorandum to the Office of Chief Counsel for review. That review might result in modifications to the conclusions herein. We will inform you of the result of the review as soon as we hear from that office. In the meantime, the conclusions reached in this opinion

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[3] [redacted] states on page 25 of its protest that personal property was "[redacted]", and fails to identify the specific amount of personal property that was paid for by the allowances.

should be considered to be only preliminary. If you have any questions, you should call Halvor Adams at (516) 688-1737.

DONALD SCHWARTZ
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By: _____
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